An International "Gold Fund"

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ONE of the promising proposals which has come to the front during the discussion of international settlements growing out of the war with Germany has been that of a so-called "gold settlement fund." Suggestions relating to this matter have appeared in the press from time to time practically ever since the beginning of the Peace Conference at Paris, and discussion of the subject had been in progress on a more or less tentative basis for some time even before the conclusion of the armistice on November 11. These suggestions, although vague so far as expressed in the public press, do not represent an idea of equal vagueness, but on the contrary embody a well matured plan which in its general outlines has the support of many competent students of finance. The problem of putting some such plan into effect, therefore, is not dependent for its solution upon the outcome of any academic discussion, but on the contrary involves only certain easily adjusted matters of technique.

Indeed, the proposal has nothing to do with the war with Germany and the treaty growing out of it, and it is erroneous to speak as if there were any such connection. Nothing has happened since the opening of the war to make such a plan more feasible or on the whole more desirable than it was before, save that the war has demonstrated the dangers and difficulties attendant upon the actual process of shipping gold, while it has also brought into a clearer light relation of credit to gold in international banking. The relation of the war to the proposal would seem to be merely that one outcome of the war may be the establishment of a condition of closer coöperation and friendship among nations which were previously deeply suspicious one of another. In this way it may well be that the foundation of an international gold fund may have been laid, and if so, there is at least one good economic result of the struggle.

PROPOSAL OF FEDERAL RESERVE BOARD

In its annual report for the year 1918, the Federal Reserve Board included the following paragraph:

> The successful operation of the gold settlement fund has suggested the possibility of avoiding shipments of gold from one country to another in settlement of balances arising out of ordinary commercial transactions, and the board is ready, if authorized to do so, to undertake negotiations looking to the establishment of an international gold exchange fund, or to assist in any way in its power in negotiations which may be begun by a government department looking to that end. The board realizes that the successful operation of a plan of this kind is dependent upon the stability of the governments concerned, and believes that definite plans cannot perhaps be worked out until a stable peace has been assured. The board would point out the importance of excluding all transactions arising from the adjustment of war obligations and of limiting the work of the fund to current commercial and exchange transactions. The gold deposited in a government bank or banks should be in the nature of a special or trust fund, and all nations participating should deposit their proper proportions of gold. Assuming that the leading nations of the world will be at peace for a long period of years, there seems to be no reason why an international arrangement of this kind should not operate as efficiently as our own gold settlement fund, which has cleared enormous transactions between distant sections of a country of vast area. The saving of loss and expense incident to abrasion and transportation charges and interest on gold transferred will be enormous, and the advantage to the commerce of the world will be incalculable. It will probably be necessary in the beginning to limit participation in the fund to the United States and the entente allies, and to a few of the leading neutral nations, but it is conceivable that all civilized countries may eventually be participants.

It is thus clear that there is available for the consummation of this gold settlement plan not only a well matured basis of theory and investigation, but also a definite banking organization which stands ready to undertake the work of installing the new system. The essential suggestion contained in this paragraph is found in the sentence which refers to "the importance of excluding all transactions arising from the adjustment of war obligations and of limiting the work of the fund to current commercial and exchange transactions." Thus limited, the board's recommendation may be regarded as the further working out or development of the gold settlement fund installed in the federal reserve system and successfully transacting the inter-federal reserve bank business at the present day.

ORIGIN OF GOLD SETTLEMENT FUND

Although the theory of clearing had been elaborately studied and recorded during the years prior to the adoption of the Federal Reserve Act, comparatively little had been said about systems of national clearing. The provisions of the Federal Reserve Act with respect to both clearing and collection constituted a very distinct contribution to the discussion of currency and banking reform—a contribution which was essential in its character because of the fact that under the Federal Reserve Act it was not proposed to install a central bank but a group of independent banks which must, therefore, communicate in some way with one another. Indeed the idea embodied in the gold settlement fund was in many ways novel in the field of American banking thought, and it is precisely at these points of novelty that suggestions were furnished which afterward afforded the basis for the present proposal to establish an international fund.

The clause of the Federal Reserve Act relating to this matter was found in a general clearance and collection section of the original law which included among other provisions a sentence authorizing the Federal Reserve Board to act as a clearing house for federal reserve banks or to designate some one federal reserve bank to act as a clearing house for all. The mechanism by which this general provision, whose intent, however, was sufficiently clear, was subsequently worked out and put into effect, is found in the report of the preliminary organization committee of the federal reserve system, which after several months of investigation rendered in June, 1914, a report, most of whose recommendations have since been accepted as the basis for the organization of the practical work of the federal reserve banks. This statement can best be understood by quoting from the report of the preliminary organization committee in question the following paragraph relating to the instalment of the gold fund. The matter is not only of importance historically but now assumes great significance prospectively because of the fact that the gold settlement fund of the United States is today practically the only exemplar from whose experience may be copied the provisions which will be necessary for the successful development of the proposed enterprise, if undertaken. The plan proposed by the committee was as follows:

To settle the balances between reserve banks, growing out of these various transactions, a clearing house is suggested, as provided in the act, in the clause which specified that: "The Federal Reserve Board . . . . may at its discretion exercise the functions of a clearing house for such federal reserve banks or may designate a federal reserve bank to exercise such functions. . . . ."

If one of the federal reserve banks should be chosen as a clearing house, for convenience of location it might be the Chicago bank; but this function of clearing would be better assumed by the Federal Reserve Board. For many reasons it would be well to establish the clearing house at the national capital. Since each reserve bank will carry a single account with every other reserve bank, subject to simultaneous debit and credit, the bulk of the interchange of business will clear itself. Balances will arise partly on account of the seasonal changes which will alter the debit and credit relationship between the districts, and partly on account of the fact that membership in the system will not be proportionately equal as between national and state banks in different regions.

The plan herewith proposed is based upon the requirement that each federal reserve bank deposit with the Federal Reserve Board clearing house all of its gold beyond that which will be sufficient to take care of local needs. This gold deposit, carried on the books of each reserve bank in a separate item as a part of its reserve funds, can be used in either of two ways or in a combination of them to effect settlement which will be explained later. Settlement need not be made between reserve banks oftener than weekly, since to require daily settlement might prevent the operation of the natural clearing effected by the interchange of ordinary business transactions. Therefore, at the close of business on each Thursday, each reserve bank should wire the clearing house the amount of the balance and should state whether debit or credit relations exist between it and other reserve banks. Allowing one day, Friday, for adjustment of any differences in the advices received, the clearing would be effected on Saturday. How this shall be done depends upon a consideration of the following possibilities:

The gold deposited with the clearing house may be credited upon a simple set of books to each bank so depositing. Clearing would then be effected by a charge and credit on the books, and advice would be made to the reserve banks. This is the simple plan, but it has one apparent disadvantage in that the banks would have no tangible evidence of the ownership of the gold other than a book credit. Consideration might, therefore, be given a plan of issuing certificates in large denominations against the proposed gold deposits as clearing house currency certificates are now issued. Upon the direction of the Federal Clearing House, the debtor reserve banks would mail these certificates to the creditor banks to pay balances. These two plans might be combined so that, although the clearing of balances would be effected by book transfers of gold at the Federal Clearing House, the debtor banks could anticipate this settlement by mailing certificates to creditor banks prior to the day of settlement. Both these plans, however, seem less effective and more cumbersome than the first plan. Very little (if any) gold would ever need to be transferred between the reserve banks, and such operations would be limited to transactions between the banks and the clearing house. The banks, in turn, would be able to loan or borrow, buy or sell

gold in dealing with each other, and the transactions would be arranged through book transfers at Washington.

EXPERIENCE UNDER FUND

While it would be interesting to detail at length the practical experience had in the operation of the gold settlement fund at Washington, established in the early part of 1915 along the lines mapped out in the committee report just cited, it will suffice for the present purpose to draw only a very few general lessons from the proposal then made. Those who disbelieved in the practical feasibility of such a method of settling transactions over the country as a whole urged that the settlement should be confined as narrowly as possible in its scope and that the adjustment should not take place very frequently. Accordingly, the settlement fund cleared only in round numbers (multiples of $1,000) and cleared only one side of the accounts between the banks. Moreover, as a concession to prejudice, it was agreed to gather the actual gold of the gold settlement fund into the hands of the Federal Reserve Board itself, and not only this, but to have the gold as thus collected and stored in the Treasury of the United States represented by gold certificates of $10,000 denomination, which should be physically in the possession of the officers of the Federal Reserve Board. The custody of these certificates was accordingly entrusted to the Secretary's office of the Federal Reserve Board, and at the outset the "transfers" in the gold settlement fund were physically effected by changing the ownership of or title to the gold certificates thus in the custody of the board.

It required an experience of only about three years to modify this plan in the direction of simplicity, while retaining all of its general theory. In consequence, the gold settlement fund is today simply a trust fund in the hands of the Treasurer of the United States and represented by an account on his books, while transfers are effected by clearing both sides of the accounts of all banks with one another and permitting tranfers to occur in any desired sum. Since the 1st of July, 1918, moreover, the clearance has been effected daily, so that today we have in operation a daily system of clearance between federal reserve banks involving the transfer of ownership in a trust fund held by the board through the Treasury Department, such transfers being effected by a book-

keeping process and being evidenced only by the changes in the accounting of the banks themselves and by the certificates issued by the custodians of the fund at Washington. On this basis transfers now occur at the rate of about one billion dollars weekly.

That the fund works well, that without it the immense operations of the Treasury Department during the period of American belligerency could not have been effected, and that the use of this system of clearing has effected an enormous saving by avoiding movements of gold and currency from one part of the country to another, is today admitted and needs no demonstration. The practical question in connection with the proposed international fund is therefore simply this: Are there conditions arising out of international relationships which are essentially different from those arising between different parts of a great country like the United States? This, in one form, is very similar to the question which was asked when it was proposed to establish a number of federal reserve banks. At that time it was pointed out that in most foreign countries a single central bank existed, but when in reply the suggestion was made that the United States in wealth, in area, and in population was equal to several such foreign countries and as such could be regarded as entitled to several central banks, there was no answer.

Application to International Conditions

Before considering the application of the idea internationally, it is worth while to observe that subsequent to the initiation of the gold settlement fund in the United States, and as a result of observation of its successful working, an attempt was made through negotiations between the United States and the South American nations to bring about the organization of an international gold fund for the peoples of the Western Hemisphere. What was then done has been described in the Federal Reserve *Bulletin* for March, 1919, in the following language:

> The growing interest in the possibility of an international gold clearance fund, especially since the report of the Federal Reserve Board for the year 1918, recalls earlier efforts in this direction made by the International High Commission. This body, established by the governments of American Republics, and consisting of national sections, each of nine jurists or financiers with the Minister of Finance as chairman, had from the outset the task of bringing about more stable financial relations between Latin America and the United States, especially

through the establishment of the gold standard, or gold exchange standard wherever not in effect. Study of this problem led to the conviction that two steps would greatly facilitate the eventual extension of substantial assistance by the United States to those Republics of Latin America which were in need of help to set their currency systems on a firm basis, first, the use of an international clearance fund, and, secondly, the use of a money account. The executive council of the commission prepared in the early summer of 1916 a draft of a convention, with a view to provide for the inviolability of such a fund. The draft and explanatory memoranda were in due course submitted to the Ministers of Finance and to the diplomatic officers of the Republics participating in the work of the commission. After careful consideration the governments of seven countries have expressed a willingness to conclude the convention with the United States, and the matter is the subject of serious study in other countries.

Delay in the practical application of the system thus devised has not been due to any unforeseen obstacle in the way of putting the proposal into effect, but has been solely the product of the usual postponements involved in getting diplomatic action from a number of countries, coupled with the natural and inevitable tendency to await post-war conditions before finally embarking upon a plan whose success would be greatly furthered by freedom of movement for specie. It is enough to say that the proposed gold fund for the peoples of North and South America has commended itself to the governments of seven countries whose officers have committed themselves to a belief in the feasibility and desirability of such an international arrangement.

INSTALLATION OF PROPOSED FUND

It is desirable that if any such plan as is now under consideration should actually be adopted, it should be applied upon the most effective, simplest and most desirable basis, without regard to individual or national prejudice or self-interest. First of all, it may be well to consider exactly what such a fund would do, following the analogy of experience had under the federal reserve system. The most obvious purpose of the fund is that which its name implies, *viz.*, "clearance" or "settlement." This occurs in the gold settlement fund just as in every other clearing house, through the obvious process of offsetting claims against one another. The only difference is that which arises out of the fact that the clearance is made by telegraph. Bank A in Dallas owes Bank B in Minneapolis $500,000. Bank B in Minneapolis owes

Bank A in Dallas $450,000. A balance of $50,000 therefore exists in favor of Bank B. Now if these two banks were situated at the same place their representatives would meet and exchange bundles of checks and drafts, with the result of "washing out" $900,000 of the aggregate indebtedness, leaving a balance of $50,000 to be paid by one bank and $50,000 to be received by the other. This might be settled by an actual transfer of gold or by the transfer of a check on another bank. Under the gold settlement fund what happens is that the checks and drafts are exchanged by mail, while the "settlement" occurs in Washington by telegraph—that is to say, each bank takes the others' word for the statement that it has a given amount of claims falling due. If through error the statement turns out to have been unwarranted, correcting entries are easily put through, but these occur seldom. The gold settlement machinery in Washington is a settlement machinery which takes no cognizance of the actual checks and drafts, but leaves them to be interchanged as their owners see fit, and at the pleasure of these owners.

This function of the settlement could occur as easily between, say, the Bank of Commerce in Toronto and the Federal Reserve Bank of Minneapolis, as between the latter and the Federal Reserve Bank of New York. There is no reason why if the Bank of Commerce were a party to the clearing transactions it should not clear as easily as any of the federal reserve banks, notwithstanding it is situated on the other side of the Canadian border. The same would be true if some agency were designated to act for all of the Canadian banks as an aggregate. This is obvious, but a more difficult case occurs if we suppose a participation in the gold settlement fund at Washington to be assigned to the Bank of England. True, the Bank of England is not much more distant from New York by telegraph or cable than is the latter from San Francisco, and communication by cable may be as prompt as the telegraphic communication between Washington and the federal reserve banks. The same thing would be true if the office of settlement were located in London. This office would hear promptly by cable from the twelve federal reserve banks and it would hear through messenger from the Bank of England. The physical process of settling might be substantially the same as under the gold settlement fund.

The first difficulty arises in the fact that such a settlement involving the Bank of England, would necessitate an arrangement for the adjustment of sterling to dollars. Indeed, some of those who are most enthusiastic about the international gold fund have proposed that as a preliminary there be established a uniform money of account. This is in no sense necessary to the establishment of the proposed fund. The difficulty of the situation is apparent only, rather than real as the gold context of the coin is the real consideration. In the first place, the Bank of England might undertake to enter into the gold settlement fund simply for the purpose of adjusting claims in sterling, in which case clearance could be effected with the federal reserve system (and its constituent member banks) for sterling claims, while the Bank of England would clear any such sterling claims as it might be carrying, the result being a balance in sterling either in England or in the United States. Exactly the same arrangement might be made with respect to dollars. Assuming that the participating banks in the United States were possessed only of dollars and sterling, and the Bank of England only of sterling and dollars, or of either, a double clearance might thus take place, there being, in effect, two gold settlement funds operated in one joint management.

This is not at all a fanciful assumption. The experience under the gold settlement fund has furnished an exact analogy to it. Some time after the gold settlement fund was first established it was desired by federal reserve agents to have a fund established for their benefit under exactly similar conditions. This was done, and today the "gold settlement fund," as generally used, includes not only the gold settlement fund proper but also the so-called "federal reserve agents' fund." In the proposed international fund there might be a "sterling fund" and a "dollars fund" with clearance in either at the will of the participating parties. Suppose, however, that after the clearance had been effected it should appear that a balance in sterling was owing to Great Britain by American banks, while a balance in dollars was owing to the United States by British banks. The question would then come up of establishing a rate at which sterling could be converted into dollars on the books of the fund. This would be no more difficult than the establishment of any foreign exchange rate. The rate which should control would be the rate current on the date of

clearance. Or if, as a result of the operations of the fund, the actual market rate were not deemed satisfactory, clearance could be effected at a purely conventional rate determined upon in advance. This would be as fair for one side in the transaction as for the other, since any advantage resulting from it in one clearance would be likely to be offset in the next. Although the operation would become more complex as more and more countries were admitted to the advantages of the clearing, the same principle which has just been developed could be worked out with entire success and with but little technical difficulty. Any such fixed valuation tends, however, somewhat to becloud the situation. The real basis of settlement should be gold by weight and any standard gold coin should serve as a means of settlement at its fine content.

We may now consider a much more difficult phase of this problem of settlement. The purpose of the settlement, as we have taken for granted, is that of avoiding the shipment of gold. We know, however, that shipments of gold grow out of so-called "adverse balances." We further know from our theory of international trade that such adverse balances correct themselves in due time in order to bring about an equality of exports and imports between trading countries. It is not desirable, therefore, to have gold shipped to rectify balances only temporarily adverse. Indeed, if such shipments were to be made on each occasion the service performed by the clearance fund would be more limited than it should be. What is desired is to provide a means of adjusting adverse balances just as such balances between federal reserve banks are adjusted. If, for example, at the present time the Federal Reserve Bank of San Francisco finds that, as a result of heavy payments through the gold settlement fund its ownership of gold in the fund is exhausted, it may if it chooses put more actual gold in the fund. It is more than likely, however, to apply for an inter-bank rediscount, in which case the federal reserve board orders a certain quantity of eligible paper held by the Federal Reserve Bank of San Francisco discounted by (let us say) the Federal Reserve Bank of New York. This means that the Federal Reserve Bank of San Francisco has turned over certain values to the Federal Reserve Bank of New York, while the Federal Reserve Bank of New York has ceded to it a portion of its ownership in the gold fund. The transaction is

essentially a sale of paper for gold. It will not be resorted to without good reason because the Reserve Bank of San Francisco does not wish to lose the discount on the bills which have thus been transferred, but if necessary it will incur this sacrifice of discount rather than be obliged to obtain and ship gold or discontinue making transfers through the gold fund. This is all simple so long as the rediscounts are made between the members of the same system, and so long as there exists a central unifying agency or board which has the power to order the rediscounts made. Needless to say, such discounts cannot cancel a permanently adverse balance but can only give time for automatic adjustment.

But internationally could the same process be applied, or not? Undoubtedly it could through the use of a similar mechanism. If, for example, the central committee of control were authorized to assign bills of certain designated kinds to any creditor country in order to secure the cancellation of the credit balance of that country as stated in gold, it would be possible for a debtor country at any time to offset an unfavorable balance by turning over bills which might be in its possession, provided they were eligible. This, indeed, is exactly what is done today through the mechanism of competitive banking. The operation of the international gold fund would in no respect alter the present situation save in the matter of technique. Indeed, it would not be precisely necessary to have the power referred to lodged in the hands of the central committee since the discounting of the eligible paper could be arranged by cable between any two of the countries which were parties to the clearance. The former method would be the simpler and more certain, but the latter could be employed, if desired. Without some such arrangement for the centralization and immediate recording of international rediscounts and sales of paper designed for the purpose of settling and adjusting temporarily adverse balances, the international gold settlement fund would fail to attain its complete usefulness. With such an arrangement it would be perhaps the most beneficial innovation in international banking since the introduction of cable communication.

SOME THINGS TO BE AVOIDED

As already intimated, there are some practices connected with the operation of any such plan which are to be avoided. In this

respect, unfortunately, the gold settlement fund of the federal reserve system affords instruction, just as it does upon its constructive side. It has been a mistake in some senses that the gold settlement fund in the United States has been a "fund" rather than a "system." It would have been as well had the gold been left where it originated—in the vaults of the federal reserve banks—instead of being massed in the subtreasuries or at Washington. No such system ought to exist at all unless the different members of it are able to trust one another's reliability and honesty. Granted such a degree of trust or confidence, the exact location of the gold is of no consequence. It is not necessary to "deposit" the gold anywhere. If it is set aside or earmarked in the vaults of the participating nation enough has been done. Eventually gold may be shipped if a permanent balance seems to have arisen against one of the holders of gold. No such shipment, however, will take place under ordinary conditions.

Again, it is desirable to avoid any measures which would tend to make the operation of the fund either expensive or slow. It was a mistake in the case of the gold settlement fund that daily clearance was not initiated at the outset. The fact that it was not so initiated gave rise to telegraphic transfers through the fund on non-clearing days, and these at times grew so numerous that it would obviously have been more economical to make the clearing more frequent. It was this fact perhaps more than any other which eventually led to the installation of the daily clearance. Even if there were but few transactions in an international gold settlement fund, the actual clearance should be as often as there was anything to afford a basis for settlement. "Red tape" operations or charges for transfers would constitute another serious barrier to success. The cost of conducting the gold settlement fund has been only about five one-thousandths of one per cent. An international fund would be more expensive, partly because it would necessitate its own staff, but at the utmost it would be an inexpensive method of adjusting indebtedness. Whatever the cost was, it should be divided pro rata among the participants after it had been ascertained.

The establishment of an international gold fund will of course be opposed by various interests and influences. Eventually, however, the application of the underlying principle of the plan will undoubtedly be adopted.